No. 12,054

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC PORTLAND CEMENT COMPANY, a corporation,

Appellant,

vs.

WESTVACO CHLORINE PRODUCTS CORPORATION, a corporation,

Appellee.

APPELLANT'S REPLY BRIEF.

MARSHALL P. MADISON,
EUGENE D. BENNETT,
FRANCIS R. KIRKHAM,
WALLACE L. KAAPCKE,
Standard Oil Building, San Francisco 4, California,
Attorneys for Appellant.

PILLSBURY, MADISON & SUTRO,
Standard Oil Building, San Francisco 4, California,
Of Counsel.

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I. THE FINDINGS OF THE TRIAL COURT ARE "CLEARLY ERRONEOUS."

It is not correct that, as appellee states (Br. pp. 5, 6), appellant asks this court to try the case *de novo* on the record or argues that the evidence preponderates and is more convincing in favor of appellant's contentions. It is appellant's position, for the reasons stated in its opening brief and in this reply brief, that the findings of the trial court are clearly erroneous within the meaning of Rule 52(a) of the Federal Rules of Civil Procedure, as that rule is applied by the United States Supreme Court and by this court:

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court

on the entire evidence is left with the definite and firm conviction that a mistake has been committed'' (*United States v. Gypsum Co.* (1947) 333 U.S. 364, 395; *Grace Bros., Inc. v. Commissioner of Internal Revenue* (9 Cir. 1949, No. 11,976) 49-5 C.C.H. Federal Tax Service, par. 9181).

The court will have in mind, however, that if it holds the decision below was erroneously based on the conclusion that appellant had the burden of proof (App. Op. Br. p. 52), and even if there were any issue upon which the decision below were not clearly erroneous, the judgment should be reversed as to such issue as well. In that event this court may either order judgment for appellant on the other issues and remand the case for a new trial as to such issue (*Borax Ltd. v. Los Angeles* (1935) 296 U.S. 10, 21), or itself find for appellant upon such issue as well, upon its own consideration of the record (*In Re Gustav Schaefer Co.* (1939) 103 F.2d 237, 242; Cyc. Fed. Proc., Second Ed., 1943, Vol. 12, sec. 6313).

II. CONTRARY TO APPELLEE'S CONTENTION, THE RECORD ESTABLISHES THAT THE CONTRACT HERE INVOLVED EXCLUDES OVERHEAD EXPENSE AND INDIRECT CHARGES FROM THE CALCULATION OF ''THE ACTUAL ADVANCE IN [APPELLEE'S] COST OF MANUFACTURE'' AND THE RESULTANT INCREASE IN PRICE.

A. The negotiations preceding the contract.

Appellee correctly states (Br. pp. 37-39), quoting *Myers v. The Texas Company* (1936) 6 Cal. 2d 610, 619, 59 P.2d 132, that ''the word 'cost' is a word of variable meaning and that it must be construed according to the

circumstances in which it is used." The contract in suit, moreover, involves more than the interpretation of the bare term "cost" or "cost of production." It involves the meaning of "cost of production" in the light of the contract's conclusive recital[1] that gypsum is a "by-product," and in the light of the contract's limitation of price increases to an amount "not to exceed the actual advance in [appellee's] cost of manufacture" of gypsum. In the light of these provisions, we submit it is clear the parties intended that price increases under this contract should be based only upon increases in the direct costs incurred in the production of gypsum.

Appellee suggests (Br. p. 17) that this construction of the contract cannot be accepted because the first draft of the contract (the so-called "Barrows draft" of September 18, 1936) specifically limited price increases to increases in "direct cost" and thereafter the parties rejected the specific term, "direct cost," and substituted in the final contract the broad term "cost of production." This suggestion is not correct. The term "direct cost" was used in paragraph 6 of the Barrows draft solely to identify the basis for the initial price of $2.80 per ton (R. 886), which became the initial price under the executed contract (R. 10). Paragraph 6 of the Barrows draft first

[1]Appellee cites two cases (Br. p. 26) to show that this recital is not conclusive. Neither case is in point. *Moffatt v. Bulson* (1892) 96 Cal. 106, 30 Pac. 1022, held simply that a recital of consideration is not conclusive. The statute which provides that the truth of facts recited in the written instrument is conclusively presumed, expressly states this exception (Cal. Code Civ. Proc., sec. 1962(2)). *Taylor v. Lundblade* (1941) 43 Cal.App.2d 638, 111 P.2d 344, holds merely that the recital in an instrument of the time and place of its execution is not conclusive, since the time and place of execution is a "non-essential fact" and "not a material part of the agreement" (p. 640).

states (R. 888, 889) that the stipulated price is based "upon the average direct cost to California to produce the materials covered by this agreement during the first year's operation of the contemplated new plant * * *." It then states that, in the event of advances in certain specific items of cost above "the first year's average direct cost *hereinabove referred to,*"[2] California may increase the price to the extent of the increase above "*said* average direct production cost." Thus each time the word "direct" was used in connection with costs, it referred simply to the estimated first year's cost on which the original price was based. This draft did not provide that price increases should be based upon "direct cost"; it provided that price increases should be limited to increases in "labor, transportation, fuel or supplies" (R. 889). Absent this limitation, the only words relating to increases are words of general reference to "cost." The parties did not, then, eliminate a specific provision that price increases should be based on increases in "direct costs"; they simply eliminated the specification of four particular items as the costs upon which price increases could be based.

Appellee concedes (Br. p. 19) that there is no testimony in the record that indirect or overhead costs were ever mentioned in conversations between Mr. Colton and Mr. Barrows. It says, however, that this is without significance, dismissing the direct cost method of by-product accounting as involving "ethereal distinctions" which the businessmen who negotiated the contract could not have

[2]Emphasis throughout this brief is supplied unless otherwise indicated.

had in mind (Br. p. 19). The intensely practical nature of this method of by-product accounting is demonstrated by Dean Jackson's testimony quoted at page 19 of appellant's opening brief that:

> "* * * most businessmen would not include as a charge to that by-product that portion of the general overhead which would go on just the same whether the by-product was produced or not. In other words, that product must stand on its own feet as to whether or not it will pay the organization to produce that product from the time it is split off from the main product * * * (R. 1203).
>
> * * * the business would have to determine whether or not, if I may use the figurative expression, they would let the material wash down the sewer or whether they would process it still further, and if they are going to process it still further, then I think that product has got to stand on its own feet and be charged only with the additional expense which would be incurred in the processing of it (R. 1207)."

As Mr. Pryor testified (R. 695-696):

> "I think the logic goes back again to my illustration of how a man determines whether or not he is going to process and sell a by-product. If it costs him out of pocket 9 cents to process it, and he can sell it when finished for ten cents, then it is good business to do so, but if by allocating indirect expenses, which would go on anyhow whether or not he was producing that product, and other expenses of an overhead nature which would go on anyhow whether he produced the product, he would have had 2 cents of indirect expense, making a total cost of 11 cents, then he would not produce the product, so it is just common sense that you only charge in mak-

ing up your mind whether to produce or not the amount you are out of pocket for it."

We do not quote the testimony of these witnesses called by appellant to measure the weight of one accountant's testimony as against that of another. We quote it to show the businessman's concept of what it costs to produce a by-product—his practical realization that a by-product is charged only with the direct or out-of-pocket expense incurred in producing it, over and above his general expenses.

In negotiating the contract Mr. Colton and Mr. Barrows—not accountants, but businessmen—were discussing the cost of a by-product—a material that would have been a "valueless waste" but for the factor that appellee's plant would be located near appellant's cement plant at Redwood City, giving the gypsum saleability to appellant (App. Op. Br. p. 22). In their discussions of the cost of producing this material these men did not at any time mention indirect or overhead costs (R. 1095, 1096), as appellee concedes (Br. p. 19). The gravamen of their discussions was that Mr. Barrows in his proposals had limited price increases to increases in only a few specific items of direct cost; that he was not willing to be limited to those items when Mr. Colton refused to grant a termination privilege to his company (R. 766); and that other items of cost—but not indirect or overhead costs—were discussed.[3] Consequently the limitation of price increases

[3]Appellant's brief heavily relies upon the statement in the trial court's opinion that "it seems clear to the court that when the parties used the term 'cost of production' they intended it to in-

to increases in "labor, transportation, fuel or supplies" contained in the Barrows draft (R. 888, 889), was eliminated from the document finally executed. Significantly, however, the parties inserted in the final contract a limitation that does not appear in the Barrows draft—the limitation of price increases to "an amount not to exceed the actual advance in [appellee's] cost of manufacture." Further, and equally significantly, the parties designated gypsum in the final contract as a "by-product," a designation which nowhere appears in the Barrows draft. Moreover, the initial price in the contract was fixed at $2.80 per ton (R. 10), a price which the Barrows draft shows was based upon the estimated *direct cost* to produce gypsum in the first year of operation of the proposed plant (R. 886, 888, 889).

In this setting of negotiation and drafting, it is conclusive, we submit, that the parties had in mind the method of accounting for the cost of producing a by-product which recognizes its special status and charges it only with the actual direct costs, ascertainably incurred in its manufacture.

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clude all costs that might be shown by accepted accounting practice." This statement, however, is founded upon the court's immediately preceding reference (R. 71-72) to "Barrows' testimony, uncontradicted by Colton, that he was unwilling to relinquish his cancellation right and at the same time to limit his costs to those items directly chargeable to the gypsum production * * *."

As shown above, this was not the testimony of Barrows. He testified simply that he was unwilling to be limited to the items of cost enumerated in his proposals. Mr. Colton testified, and his testimony is uncontradicted, that neither Mr. Barrows nor anyone else representing the other party ever suggested to him that any price increase should be based on any items other than direct costs of the manufacture of gypsum (R. 1095-1096).

The general findings of the court below that appellee has determined its costs in accordance with the contract (R. 50-55), rest upon the basic finding (R. 48) that it is unnecessary to find whether or not the gypsum produced by appellee is a by-product, since "good accounting practice requires the inclusion of 'overhead expense' and 'indirect charges.'" These findings erroneously assume (Opinion, R. 69, 72), as does appellee's fundamental argument (Br. pp. 17, 18), that the issue in this case may be resolved merely by determining whether appellee's internal system of accounting, adopted uniformly throughout its own nationwide operations (without any reference to this particular contract or the intent of the parties thereunder), is in accordance with "good accounting practice." But of course that is not the question. The question here is whether the parties to this particular contract intended that the "actual" ascertainable direct costs of producing gypsum at the Newark plant should be the costs used in determining the "cost of production" for the purpose of arriving at price increases under this contract.

The extreme nature of appellee's contention that all indirect items of cost may be added is strikingly illustrated in the events that actually have occurred. Appellant negotiated this contract with California Chemical Company, a local manufacturing concern (R. 742). After the contract was made California Chemical Company consolidated with a number of other companies (R. 771) and then transferred its assets, including its rights and obligations under this contract, to Westvaco Chlorine Products Corporation (R. 748, 771), a large national concern with plants all over

the United States (App. Op. Br. p. 17). This corporation has assigned to the cost of production of gypsum under the contract a portion of its over-all indirect expenses, including "West Coast" overhead expenses and a share in the expense of its New York office—four floors in the Chrysler Building, staffed by 150 employees (R. 1081). Now Westvaco has recently merged with Food Machinery Corporation, and is a division of Food Machinery and Chemical Corporation.[4] If appellee's contentions are correct, this worldwide manufacturing concern may add still other indirect and even more remote and unexpected expenses to the cost of production of gypsum on the ground that its internal accounting practices provide for the apportionment of such costs to this by-product and experts say that this is in accord with "good accounting practice."

The sum of the matter is that appellee's contentions and the findings of the court below totally ignore the contract's designation of gypsum as a by-product to be produced by California Chemical Company's plant on "Canal Head at Newark, California" (R. 8), and totally ignore the express provision in the contract that price increases shall be limited to "an amount not to exceed the actual advance in [appellee's] cost of manufacture." Nowhere in appellee's brief is there any suggestion that these portions of the written instrument can have any significance whatever if its contentions are adopted. The construction for which appellant contends, on the other hand, is not only in accord with the history of the negotiations between

[4]Appellant expects to move the court for a substitution of parties.

the contracting parties, but also gives effect, as proper principles of interpretation require (Cal. Civ. Code, sec. 1641), to every part of the contract.

B. The practical construction of the contract by the parties.

Appellee's argument as to the effect of the conduct of the parties in connection with the first price increase of October 5, 1941, is based entirely upon speculation concerning disclosures it assumes, without any support in the record whatsoever, were made by appellee to appellant's Mr. Canvin (Br. pp. 31-33, 35-36). Appellee's inferences are directly contrary to the facts indicated on the face of the letter of October 2, 1941, written to Mr. Canvin by appellee's Mr. Hurlburt (App. Op. Br. p. 25). This letter of October 2, 1941, shows that a conference was held between appellant's Colton and Canvin and appellee's manager Wallace the day before it was written, but there is nothing in the record to show what occurred at the conference.[5]

Mr. Canvin, then appellant's secretary and treasurer, died June 3, 1944 (R. 597). His testimony therefore was not available to appellant. Appellee, while now suggesting (Br. p. 33) that Mr. Canvin knew the first price increase of 18 cents included an increase based on over-

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[5]The court below was seriously in error in this connection. It is stated in the opinion (R. 70), without any support in the record, that

> "While Colton was being shown over the plant, Canvin and defendant's accountant went over the figures."

The court must have confused the 1941 conference with a visit in 1944, in connection with the second price increase. Then appellant's representatives Flick, Riddell, and Canvin went to the Newark plant, the figures relating to *that* increase were gone over (R. 344), and Flick was shown over the plant (R. 124).

head and indirect charges, made no effort to produce any evidence as to what actually occurred at this conference. Mr. Hurlburt, appellee's chief accountant who wrote the letter of October 2, 1941, was not called as a witness by appellee. Mr. Wallace, who is appellee's western manager and the one who conferred with Colton and Canvin, testified as a witness for appellee but said nothing as to any disclosure made either to Colton or to Canvin. No cost records that appellee supposes were shown to Mr. Canvin were produced by appellee, and the record establishes without conflict that appellant itself has nothing in its files but the letter of October 2, 1941, and the statement that accompanied it (R. 103).

The letter written by Hurlburt to Canvin compels the conclusion that Canvin was not informed of the basis for the price increase at the conference. It begins (App. Op. Br. p. 25), "In accordance with request of yourself and J. H. Colton, while in conference with Mr. Wallace yesterday, we have analyzed gypsum production costs * * *" Plainly, the analysis of gypsum production costs followed the conference and was made pursuant to a request at the conference. Thus it is clear that in the letter of October 2, 1941, and the statement submitted with it, appellant obtained information it had not previously been given—information as to the costs which appellee considered supported the first price increase. Hurlburt's letter further shows that appellee's attention at the time of the first price increase and in the analysis of gypsum production costs referred to in the letter, was confined to direct costs. Neither the letter nor the statement which accompanied it referred to anything but direct cost (R.

100, 101). Appellee intimates (Br. p. 33) that Mr. Canvin knew overhead and indirect charges had entered into the price increase, and that his request was for only a limited or partial statement as to the items of labor, material and power (Br. pp. 30, 31, 33, 35). The letter itself shows this is not true—that what was requested was an analysis of gypsum production costs.

The letter of October 2, 1941, states that the enclosed recapitulation for the two years then compared of labor, material and power costs—only three items of direct cost —"accounts for 15 cents per ton of the 18 cents per ton increase." Appellee's subsequent corrected account (furnished in 1944), of the costs claimed to support the first price increase showed that, contrary to this earlier representation, direct costs had increased only 9 cents, and 9 cents of the first increase was based on indirect charges (App. Op. Br. pp. 26, 27). The shift of position indicated by this disclosure is sought to be avoided by appellee's argument that except for a difference of one cent in power cost in the 1940-41 period, the figures shown in the 1944 statement for labor, material and power were the same as those shown by the 1941 statement (Br. p. 35). This argument is entirely beside the point; if 9 cents per ton of the first increase was based on indirect charges, the 15-cent increase in these three items of direct cost would not "account for" 15 cents of the 18-cent increase.

In appellee's brief it is twice stated (Br. pp. 32-33) that the evidence is undisputed that in calculating the first price increase, overhead and indirect charges were included in cost of production. The record reference given to support this statement in both instances is only to the

new statement of the 1941 costs, furnished by appellee January 29, 1944 (Def. Ex. A., R. 351-356), after appellee on January 14, 1944, had claimed its second price increase (Plf. Ex. 2, R. 119-121), including a large increase attributed to increases in overhead and indirect charges (App. Op. Br. p. 50).

Appellee also seeks to show that appellant's conduct at the time of the third price increase indicated a recognition of the propriety of basing price increases upon increases in overhead and indirect charges (Br. p. 34). Appellee refers to the fact that in work sheets prepared by appellant's employee Mr. Bannard, upon which he noted the items of cost shown upon appellee's records, and "on which he noted all adjustments thereof that he considered should be made" (Br. p. 34), there was no adjustment excluding the increases in overhead. This is an entire distortion of the record. Mr. Bannard's superior, Mr. Flick, who instructed him as to the examination to be made of appellee's costs, testified "Bannard's job was not to allow or disallow anything. Bannard's job was to go down, look at the figures, and come back and tell me what he found" (R. 416). Mr. Flick further testified that Bannard's work sheet did not represent any final judgment by Mr. Bannard as to what he approved or did not approve. "His work sheets were to enable him to report to me" (R. 417). At the time of Mr. Bannard's examination of appellee's costs, appellant had long since made its objection to price increases based upon increases in overhead and indirect charges (App. Op. Br. p. 5). Following Mr. Bannard's visit, this objection was again promptly stated in appellant's letter to appellee of November 4,

1946 (Plf. Ex. 13, R. 232-238, 241-244), which was approved by Mr. Bannard before it was sent (R. 417). Obviously no "practical construction" by appellant, accepting price increases based on overhead and indirect charges, can be inferred from anything that occurred in connection with Mr. Bannard's fact-finding examination of appellee's accounts.

C. The expert testimony.

Since the term "cost" or "cost of production" is one of variable meaning, depending upon the circumstances in which it is used, and since it is clear on the face of this contract and from the history of the negotiations that the parties intended a limited concept of "cost of production" for use in calculating price increases, the testimony of experts as to generally applied principles of accounting for the cost of manufactured products at large is not determinative. The accountants were not seeking to interpret this particular contract, nor did their testimony contemplate its particular language or the background of its negotiation.

It is unnecessary to consider the extent to which some of the accounting experts would prefer an all-embracing concept of cost of production. The testimony of appellee's accounting experts was that one method of accounting ignores a by-product's special characteristics and treats it as though it were a major product or co-product. But the same experts also agreed that another well-known and widely practiced method of by-product accounting (the method considered preferable by the experts who testified for appellant) recognizes that a by-product is

produced incidentally to the production of the principal product for which the overhead and indirect charges would be incurred in any event, and realistically charges to the cost of the production of the by-product only the direct costs—the costs ascertainably incurred because of its production (App. Op. Br. pp. 19-21). This contract states that appellee's Newark plant was "primarily designed to produce magnesium oxide in its various forms, which plant will produce as a *by-product* substantial quantities of gypsum * * *" (R. 8). This recital can mean only that the latter method of accounting is the one that was contemplated by this contract and is the practical method which the practical businessmen negotiating the contract had in mind.

Appellee's disregard of the intent of the parties to this particular contract is illustrated by its repeated reference (Br. pp. 2, 27) to the accounting methods used by appellant at its Gerlach plant. As we have previously pointed out (App. Op. Br. p. 37) no by-product is produced in this Gerlach plant; and of course appellant's calculations for its own internal purposes of the cost of the joint products produced there has nothing to do with the accounting methods that are proper under this contract for the purpose of calculating price increases within the limits that the parties intended.

Appellee attacks as unsupported by the record (Br. pp. 26, 27) the statement by appellant (App. Op. Br. p. 20) that the independent accountants called by appellee recognized that the exclusion of overhead and indirect charges from cost of production of a by-product is an accepted and widely practiced method of accounting—

indeed, the method most commonly found in practice. This attack is unwarranted. Appellee refers to the most common procedure in the case of a by-product as the keeping of no cost records at all (Br. p. 27). This, of course, cannot be said to be a method of accounting for the cost of production of a by-product. Appellee's expert Farquhar did testify (R. 1119, 1120) that where the cost of production of a by-product is determined, the most common practice is to start figuring the cost of the by-product at the point of separation from the material going into the main product. Asked whether no distinction were drawn in cost accounting between a by-product and a co-product of primary product, Farquhar answered that in his opinion no such distinction should be drawn in theory, but admitted it frequently is drawn in practice (R. 1119):

"In theory, no. In practice, frequently."

Again, asked whether the more usual practice does not confine the by-product costs to those incurred after its separation from the main product, he said (R. 1120):

"* * * I could think of more instances where they do not refine the costs than where they do."

Although appellee's expert Maxwell sought to equivocate on this question, his cross-examination brought out that the principal authority he cited in support of his views—"The Cost Accountant's Handbook" (R. 1145)—recognized this method of by-product cost accounting (R. 1156, 1161-1166). Indeed, in discussing the method for which appellee contends—the allocation of overhead and indirect charges to a by-product—this text states "that there is no logical basis for this view, except the fact that a cost is attached to each product" (R. 1166).

D. The unreasonable result of appellee's interpretation.

Appellant has pointed out (App. Op. Br. p. 16) that appellee's interpretation would give it price increases more than three and one-half times the advance in its total asserted cost since 1938, the first full year of the Newark plant's operation, and would give it a profit of eight times the initial profit. Appellee says the use of the year 1938 is "particularly odious" (Br. p. 9). That year was used because the Barrows draft of September 18, 1936, shows the initial contract price of $2.80 per ton was based on the estimated cost during the first year's operation (R. 888, 889). Appellee prefers a comparison of cost in the twelve-month period ending June 30, 1940, with the cost in the last accounting period (Br. p. 9). It thus conveniently selects the year of lowest cost to compare with that of highest cost (R. 565). Even this comparison does not produce a figure that is equal to the total of the price increases claimed. In any event, this comparison is invalid. This lowest cost year ending June 30, 1940, did not in any way figure in the shaping of the contract, as the first year of operation definitely did; nor has the relationship between the lowest and highest cost years anything whatever to do with the operation of the "escalator" provisions of the contract, which move only upward, not downward.

Appellee stresses the unusual features of paragraph (6) of the contract—that its escalator provisions are not related to the cost of production in any base period and price increases are determined by comparing the cost in any twelve-month period with the immediately preceding twelve months (Br. p. 8). We agree with appellee that

this unusual feature of the contract must be borne in mind in the consideration of this case. Because of this feature, and because of the further feature that paragraph (6) operates only upward, not downward, this contract is different in a most essential respect from the familiar "cost-plus" contract under which prices fluctuate up and down as cost of production varies. If this were a "cost-plus" contract, appellant would not be faced with the serious prejudice to which it is subjected by the error of the court below, for inaccuracies in computing increases would be offset when decreases occurred. Under the contract that was executed, however, the error of the court below would permit the pyramiding of improper increases, ever upward, to a point where appellant would be forced to terminate the contract.[6]

Appellant does not complain of these unusual features of the price clause in the contract. It does urge most emphatically, however, that the practices followed by appellee and approved by the decision of the court below are highly prejudicial, since they result in erroneous increases that are permanently fixed in the price, and produce an unreasonable and oppressive result that clearly could not have been intended by the contracting parties.

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[6]Appellee contemplates with equanimity the prospect that appellant may be forced to terminate the contract, and regards this as a complete remedy (Br. p. 6). This overlooks the very obvious fact that such termination would subject appellant to the major dislocation of its business consequent upon the loss of a long-term supply of substantial quantities of the gypsum it needs.

III. REPLY TO APPELLEE'S ARGUMENT WITH RESPECT TO THE PARTICULAR ITEMS OF COST (BRIEF FOR APPELLEE, PAGE 40 ET SEQ.).

A. Plant overhead.

What we have said demonstrates, we submit, that no indirect items of expense, including general plant overhead, may enter into the calculation of price increases under this contract. This is true, also, of other items hereinafter discussed. As to these items, however, additional considerations are present (as we showed in our opening brief) and we turn now to appellee's discussion of these items.

B. New products research.

It is simply an obvious fact that research upon new products is not a cost of production of gypsum (App. Op. Br. pp. 34-35). One need not be a chemist or an accountant to perceive this. Appellee's suggestion (Br. pp. 44-45) that this court can take judicial notice of the fact that research is a necessity in modern technology, is irrelevant. However necessary or desirable research upon new products may be to appellee's business, the expense of such research is merely one of appellee's general expenses of doing business, and is not a cost of *production* of gypsum.

Appellee seeks to show a benefit to gypsum from "new products" research by urging that if new products are developed, such new products may bear some portion of appellee's overhead (Br. pp. 43, 44). This, of course, is immaterial to the purposes of this contract, under which price increases that once take effect are not eliminated when cost goes down.

Regarding appellant's objection to that portion of the third price increase based upon a claimed increase in the cost of research, including "new products" research, appellee states (Br. p. 41) that there was no evidence as to what portion of the aggregate charge was for "new products" research. The reason for this is that appellee would not disclose that segregation. The court will note that the account headings on the accounting schedule which shows the breakdown of appellee's charges for overhead (R. 569) separately list "Research" and "Research, New Products." In filling in this accounting schedule, appellee grouped these items together by inserting a bracket, and inserted only a gross figure covering both items. The record does show that all but a nominal amount of the research charge involved in the second price increase was for "new products" research (App. Op. Br. p. 35; Appellee's Br. p. 41). Since appellee would not divulge the extent to which "new products" research contributed to the aggregate research charge involved in the third price increase, it may be inferred that the same was true as to the third increase also.

In any case, the cost of research should be excluded from the calculation of price increases for the same reasons as call for the exclusion of other overhead charges, and for the further reason that research, whether upon new products or otherwise, is not an expense of *production.* To the extent the research charge includes the cost of research upon new products, it must *a fortiori* be eliminated.

In other respects also appellee comments upon the absence of evidence as to the breakdown of the research

charge involved in the third price increase (Br. pp. 41, 42), including the absence of evidence as to the amount charged to gypsum on account of the research project seeking to eliminate gypsum. These further breakdowns, of course, are peculiarly within the knowledge of appellee and could not have been provided by appellant since appellee would not give, as to the third price increase, even a segregation between research and "new products" research.

C. General and administrative expenses.

We need not repeat the evidence recounted in appellant's opening brief (pp. 36-38) and the testimony of appellee's own accountants there discussed which requires the exclusion of this group of expenses from the calculation of price increases.

The accounting schedule of appellee's overhead charges shows a group of items designated as "West Coast" expenses (R. 569). Seeking to show that these expenses are not what this designation indicates, appellee says (Br. p. 45) that the accounting sheets comprising Plaintiff's Exhibit 18 (including this overhead schedule) were prepared by Mr. Flick. What Mr. Flick did was simply to write in the headings and account titles he took from the headings and account titles furnished him by appellee (R. 584, 115). The classifications appearing on these schedules follow appellee's classifications (R. 584) and were made pursuant to classifications previously given by appellee. Appellee so stipulated at the trial (R. 588). Appellee adopted the forms thus prepared for the purpose of furnishing appellant information as to

its costs, and filled in the figures and other matter appearing upon the schedules in light handwriting as distinct from the dark handwriting that is Mr. Flick's (R. 584, 585).

Appellee now states (Br. p. 45) that the designation of "West Coast" expenses is not the designation under which the items are carried on appellee's books. If this is true, it is irrelevant. It is the true nature of an expense, and not the designation given to it upon appellee's books, that controls. In its effort to disguise the true nature of these "West Coast" expenses, appellee lifts from its context a fragmentary portion of the testimony of its office manager, Watt (Br. p. 45). All of Watt's testimony on this subject taken together leaves no question that these items are general expenses of appellee's West Coast operations. He testified that the expenses designated as "West Coast" expenses on the accounting schedule relating to overhead (R. 569) are "expenses pertaining to the West Coast operations" (R. 930). These operations embrace the Newark plant, the Chula Vista plant and Hollister mine (R. 930). The "West Coast General Expense" shown on this accounting schedule is, for example, a portion of West Coast general expense allocated to Newark (R. 931). The "West Coast, New York Office" expense is a portion of that office's expenses prorated to the West Coast, again prorated among the West Coast plants, and finally prorated at Newark among the products there produced, including gypsum (R. 1050, 1051). The "West Coast Exploration" expense is the cost of exploration of mining and new mines, "mines anywhere on the coast" (R. 1051). This

item was allocated among the several plants and again allocated at Newark among the several products, including gypsum (R. 1052). All the items designated as West Coast expenses on the accounting schedule in question pertain to appellee's West Coast operations (R. 930).

Appellee refers (Br. p. 46) to the testimony of its expert Farquhar as to allocations of administrative expense made under certain Navy contracts. What was or was not done in the allocation of administrative expense under contracts between shipbuilders and the Navy, the terms of which are unknown, is irrelevant.

D. Indirect shipping and air compressor charges.

Appellee virtually concedes the error of the court below in permitting the third price increase to include 3 cents per ton caused by its use of inconsistent accounting methods in the periods involved in the cost comparison for these items (Br. p. 48). There is no evidence in the record conflicting with the testimony of the accountants called by appellant, that consistent accounting methods must be employed in the two periods compared (App. Op. Br. p. 41).

Appellee claims as a virtue that it has employed the same accounting procedures with regard to gypsum as have been applied to the other products produced at Newark and that the accounting changes in question were not adopted for the purposes of giving gypsum adverse accounting treatment (Br. pp. 47-48). The question is not the purpose for making the changes, but their effect of producing a fictitious increase on appellee's books in the cost charged to gypsum (App. Op. Br. p. 40).

Eliminating the price increases based on this fictitious cost increase will not mean as appellee suggests (Br. p. 48) that appellee's accounting techniques must remain static. For its own internal purposes, appellee may change its methods of allocation or any other accounting technique whenever and as often as it wishes. For the purposes of this contract, however, such changes may not be used as the basis for increasing the price charged to appellant in respect of items of cost that actually have remained constant.

Appellee has remarked upon the importance appellant attaches to the 3 cent per ton error here involved, although at the time of the first price increase it did not further inquire into the basis for the 3 cent excess of that increase over the 15 cents appellee advised was "accounted for" by increases in labor, materials and power (Br. pp. 32, 48). At the time of the first price increase in the relatively lesser amount of 18 cents per ton, appellant had every reason to believe that appellee's practices were in conformity to the contract, and in that setting quite reasonably paid the increase without further detail. Appellee views very differently, as anyone would, an erroneous charge of 3 cents per ton appearing in the third price increase, after appellee had claimed two increases in the major amounts of 78 cents per ton and 60 cents per ton, and after appellant had long been aware that appellee's practices were objectionable in important respects.

As to appellee's changes in accounting methods with respect to other overhead items than the indirect shipping and air compressor charges, appellee states (Br. p.

49) there is no evidence that such changes resulted either in an increase or decrease in the asserted cost of gypsum. This evidence is lacking because appellee's office manager Watt was to prepare and produce a tabulation showing the effect of these further changes but did not do so (App. Op. Br. p. 43).

E. Straight-line depreciation.

There is a specious appeal in appellee's principal argument concerning its use of the straight-line method of depreciation, namely, that when the quantity of gypsum produced goes down the cost per ton must necessarily go up (Br. pp. 51, 52). The truth of the matter is that the gypsum equipment will last for a certain length of time and during that time a certain quantity of gypsum will be produced. The true unit cost of depreciation is a constant cost for each ton of gypsum produced, obtained by dividing the number of tons produced into the cost of the gypsum equipment. In ordinary circumstances the commonly used straight-line method of depreciation will serve the purpose for which it is intended and for which it is used by appellee—charging off the equipment and creating a reserve adequate to replace it at the end of its useful life (Br. p. 54). That purpose, however, has no relationship whatsoever to the result of using the straight-line method of depreciation for the purpose of calculating price increases under this contract. After the drop in tonnage occurred, which created the 7-cent per ton price increase claimed by appellee in respect of depreciation, the tonnage promptly rose again to more than the initial rate of production (App. Op. Br. p. 47). The result of charging this 7-cent per ton increase to appellant

would therefore be to place in appellee's depreciation reserve an amount far greater than necessary to replace the gypsum equipment.

Appellee's fallacy lies in the assumption that the straight-line method, which is just a convenient device appropriate for the purpose of creating a fund to replace the equipment, is necessarily proper under this contract. This contract is concerned only with the comparison of cost in two accounting periods to ascertain the *"actual advance"* in that cost. The real depreciation cost for each ton of gypsum produced is constant and no "actual advance" in that cost takes place merely because the tonnage produced in one accounting period is less than in another.

F. Sulphuric acid.

It is appellee's contention that discontinuance of bromine production in September, 1945 was a basic change in the operating conditions of the plant which required that thereafter the sulphuric acid be charged to gypsum (Br. pp. 54, 56). It appears (Br. p. 54) that from 1930 to 1937, bromine was the only product produced at Newark. Strangely enough, the commencement of gypsum and magnesium production in 1937 is not regarded as a basic change, and although it is said sulphuric acid is necessary to gypsum production (Br. p. 55), no charge for sulphuric acid was made to gypsum at any time after its production began in 1937.

Appellee claims as a "consistent accounting procedure" its practice of always charging sulphuric acid to bromine (Br. p. 55). Of course appellant had no occasion to be

concerned with the treatment of sulphuric acid prior to the date when it first appeared in an asserted price increase. There is consistency in that the sulphuric acid charge has never before been made to gypsum. The inconsistency lies in the fact that gypsum was newly charged with sulphuric acid after September, 1945, although sulphuric acid has always served the same function in gypsum production, the process of manufacturing gypsum has remained unchanged, and the sulphuric acid cost has not increased. It may be said equally of gypsum as appellee says of magnesia (Br. p. 56) that "in the entire history of the company there has never been a charge against magnesia for sulphuric acid". The fact that appellee in September, 1945, began charging the sulphuric acid cost to gypsum cannot be claimed by appellee as establishing an "accounting procedure" that it consistently employed from the very inception of its operations (Br. p. 57), for it is the very charge first made to gypsum in 1945 that is the subject of the litigation.

The fallacy of appellee's argument that the cost of sulphuric acid "must be charged somewhere" (Br. p. 57) and "it was essential" to charge it to gypsum (Br. p. 56) is apparent. It does not follow from appellant's argument that the charge for sulphuric acid will have to be made to magnesia. Where appellee charges the sulphuric acid cost for its own purposes, and whether for those purposes it is charged to gypsum or not, is not relevant to this contract. This contract is concerned only with correct comparison of cost of production in two periods to determine the "actual advance" in cost. Appellant urges simply that the gypsum process and the use therein of

sulphuric acid have not changed, there has been no "actual advance" in the cost of manufacture of gypsum in the amount of the new charge for sulphuric acid, and therefore the price to gypsum may not be increased by that amount.

We have already pointed out the intolerable consequence of the argument that the cost of production of gypsum and the "actual advance" in that cost are determined by successive discontinuances and resumptions of production of a different product in a separate portion of the plant, although the gypsum process goes on exactly as before (App. Op. Br. pp. 44, 45).

G. Bittern.

The bittern charge is involved because it is the source material from which the principal product of the plant, magnesium oxide, is derived (App. Op. Br. pp. 8, 9). Its cost is an expense incurred for the production of the primary product, prior to the separation of the by-product (see supra, pp. 5, 16). The charge for bittern that is made to gypsum is purely arbitrary. Appellant noted its objection to this item on this ground (App. Op. Br. pp. 18, 51). When asked by the court below what this charge was based on, Mr. Watt testified (R. 1031):

> "That is all we can say, your Honor, is that it is just an arbitrary charge."

Here again appellee confuses (Br. p. 58) the question of the cost gypsum may "bear" on its books, with the question as to the type of charges the contracting parties intended to be used in calculating price increases under

this contract. It is not of moment whether on appellee's books gypsum is made to "bear" an arbitrary charge for bittern. It is of moment that changes in cost based on that arbitrary charge may not be reflected in the price charged to appellant. As appellee has observed (Br. p. 58), there was a reduction of 2 cents per ton in this item in connection with the last price increase. It does not otherwise figure in the price increases in litigation.

IV. THE COURT BELOW ERRONEOUSLY BASED ITS DECISION ON THE GROUND THAT APPELLANT HAD THE BURDEN OF PROOF.

Essentially this litigation involves claims made by appellee against appellant for increases in the price of gypsum based upon asserted increases in cost, and appellant's bringing these claims before the court in a declaratory relief suit for a declaration whether it were liable upon these claims. Its basic prayer was that the court declare the rights and other legal relations of the parties under the contract (R. 7). This is the classic example of the case in which the party who is nominally the plaintiff has not the affirmative of the issue and does not bear the burden of proof, as demonstrated by the authorities appellant has cited (App. Op. Br. pp. 54-58). Appellee's principal reliance (Br. pp. 62, 64) is upon *Travelers Ins. Co. v. Drumheller* (W.D.Mo. 1938) 25 F. Supp. 606, which held that the plaintiff always has the burden of proof whether or not it has the affirmative of the issue. This ruling, however, is not the law in that circuit. *Reliance Life Insurance Co. v. Burgess* (8 Cir.

1940) 112 F. 2d 234 "discredits and overrules" the *Drumheller* decision (Borchard, Declaratory Judgments, 2d Ed. 1941, p. 407, note 4) (App. Op. Br. p. 56).

Appellee misunderstands the California law on the point (Br. pp. 63, 64, 66). It is clear from Section 1981 of the Code of Civil Procedure of California and from the decisions in *Roadside Rest. Inc., v. Lankershim Estate* (1946) 76 Cal. App. 2d 525, 173 P. 2d 554, and *Dunn v. County of Santa Cruz* (1944) 67 Cal. App. 2d 400, 154 P. 2d 440, that the party having the affirmative of the issue has the burden of proof. In each of the California decisions cited, the plaintiff in the declaratory relief suit did have the burden of proof, but because it had the affirmative of the issue involved in the case, not because it was plaintiff. That portion of Section 1981 of the Code of Civil Procedure of California which states "the burden of proof lies on the party who would be defeated if no evidence were given on either side" does not alter the situation. In a case such as the one at bar, where the defendant has the affirmative of the issue whether it is entitled to the price increases it claims, the defendant would be defeated if it gave no evidence upon that issue, once the plaintiff had established the controversy and the jurisdiction of the court. It would have failed to substantiate the price increases it claimed and asserted in its pleading, and failed to establish its right to relief upon its prayer (R. 33) that the court declare its cost of producing gypsum as determined by it from time to time and the resultant increases in price established by it have been in accordance with the terms and provisions of the contract (*Bauer v. Clark* (7 Cir. 1947) 161 F. 2d 397).

Nor is the situation altered by the fact that, as appellee has put it, appellant's complaint sought "affirmative relief" (Br. p. 67). What appellant sought was a declaratory judgment establishing whether it is liable upon claims made by appellee. Since certain payments for gypsum, in the increased amount claimed by appellee, had been made by appellant under protest, declaratory judgment of appellant's nonliability for the claimed increases would necessarily mean these payments made under protest were not owing, and of course appellant sought a judgment that would determine its right to recover those payments. The basic issue, however, was not whether appellee owed appellant $9,405.93. The issue was whether appellee was entitled to be paid for gypsum the increased price claimed by it and asserted by it in its pleading.

Appellee's burden of proof did not, as appellee contends (Br. pp. 59, 68), become appellant's burden by reason of the fact that appellant opened and closed at the trial. That situation was before the court in *Standard Accident Ins. Co. v. Cloutier* (1943) 92 N.H. 449, 32 A. 2d 684, a declaratory relief suit in which the defendants made the same contention. The court held (p. 686) that the plaintiff did not waive the evidentiary rule of the burden of proof that was on the defendants, and that the defendants waived the procedural rule by permitting the plaintiff without objection or exception to go forward and have the closing. (See also *Bauer v. Clark* (7 Cir. 1947) 161 F. 2d 397, 401).

Appellee endeavors to show from the pleadings that appellant had the affirmative as to appellant's claimed cost and price increases (Br. pp. 60, 61). Essentially this

is an effort to convert the complaint's negative allegation that appellee's cost "had increased *not more than*" a certain amount, to an allegation that appellee's cost of production "had increased"; to convert the negative allegation that appellee "was entitled to be paid *not more than*" a specified price, into an allegation that appellee "was entitled" to be paid (Br. p. 61). This is mere play upon words.

Appellee considers it would have been necessary for appellant to prove the proper cost figures (Br. p. 62) and states that complete facts and records as to appellee's costs were available to appellant (Br. p. 67). Appellant was permitted to review certain of appellee's books, but it is one thing to have available all records, starting from the original entries of charges for the time of laborers, materials used, and the like, and records bringing those charges forward through various summary books up to their final compilation in the accounting statements; it is another thing to start with the final statements, as appellant had to do, and attempt to trace back through the records to the underlying data for verification. We have noted above that appellee would not divulge certain information as to its research charges (supra p. 20), and did not produce its tabulation showing the effect of certain changes in accounting method (supra p. 25). In each instance the resulting lack of evidence is now claimed as a benefit to appellee.

Appellee argues (Br. p. 59) that it cannot be ascertained from the record to what extent the trial court "felt" that appellant had the burden of proof. On the contrary, it is clear from the court's opinion that the decision was ex-

pressly based on the conclusion that appellant had the burden of proof. The court pointed out that, in its opinion, the plaintiff had "failed to prove" that the price raises were unjustified and based its ultimate decision upon this ground (R. 73).

V. PARAGRAPH (5) OF THE CONTRACT.

Contrary to appellee's assertion (Br. p. 69), the controversy over the method of sampling is properly in issue. The second count of the complaint (R. 5, 6) involved differences between the parties over deductions under paragraph (5) of the contract, and the complaint prayed that the court declare the proper method of determining the conformity or non-conformity of the gypsum to the specifications (R. 7). Decision on that point does not require, as appellee suggests (Br. pp. 69, 70), inserting in the contract any missing provision.

Whether the gypsum tendered to appellant does or does not conform to the specifications can be determined only by the analysis of samples. The finding by the court below recognized this (R. 57, 58). Appellee concedes that for the purpose of such analysis a sample of "each shipment of gypsum" should be used, but says the aggregate quantity shipped in a 24-hour day is a shipment (Br. pp. 69-70). This clearly is untenable. It is clear that each carload, containing 50 or 55 tons (R. 212, 213), constitutes a shipment. The nine-year use by the parties of samples of each carload makes it clear that they so understood. This is further demonstrated by the fact that sometimes carload shipments go direct to appellant's customers (App. Op.

Br. p. 61). There is no shred of evidence to support the artificial finding by the court below (R. 58) that the aggregate quantity of gypsum shipped to appellant in a 24-hour day constitutes a "shipment."

CONCLUSION.

We respectfully submit that the judgment of the court below is erroneous and should be reversed.

Dated, San Francisco, California,
May 10, 1949.

Respectfully submitted,
MARSHALL P. MADISON,
EUGENE D. BENNETT,
FRANCIS R. KIRKHAM,
WALLACE L. KAAPCKE,
Attorneys for Appellant.

PILLSBURY, MADISON & SUTRO,
Of Counsel.